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OECD: The Economic Impact of a Reduction in Oil Prices

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An Intelligence Assessment

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EUR 83-10105
April 1983

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An Intelligence Assessment

This report was prepared by
Office of European Analysis, with
major contributions from country analysts.
Comments and queries are welcome and may be
addressed to the Deputy Chief, European Issues
Division, EURA,

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This paper was coordinated with the National
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Key Judgments

Information available as of 20 March 1983 was used in this report.

The oil reference price of $29 per barrel, agreed to at the March OPEC meeting, continues under pressure from some oil exporters and spot market prices. If oil prices continue to fall over the months ahead, even larger benefits should accrue to oil-importing nations. The ultimate impact on the major developed countries would depend on how far and how fast prices drop, as well as on the policy options chosen by the governments of those countries.

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We compared the impact of a fall in the price of crude oil to $25 per barrel on average in 1983, and remaining at that level in nominal terms through 1985, with oil priced at $33.50 per barrel during the same period. We estimate the economic impact of that price differential on the Organization for Economic Cooperation and Development (OECD) countries as a group to be:

- An increase in the GNP growth rate of 1 percentage point the first year and another 0.5 percentage point in each of the next two years.
- An increase in employment of some 2.5 million people by 1985, with most of the job creation occurring in the second and third years; by 1985 unemployment rates would be below 9 percent for all the major OECD countries except Canada and the United Kingdom.
- A fall in the average inflation rate of about 1.5 percentage points the first year, with gains dissipating rapidly thereafter.
- An initial slowdown in OECD exports that would be quickly reversed as new import demand by oil importers overcame the decline in sales to oil exporters.

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Among the major foreign countries, Japan and West Germany would benefit most because of the large savings on oil bills; the rate of economic growth in the first and second years would increase substantially for both. France and Italy would also enjoy a large short-term stimulus, but the positive effects would dissipate quickly; both would show less improvement in investment rates in the second and third years of the price cut and relatively more import growth. The United Kingdom and Canada, although both are net energy exporters, would also gain because of the incremental growth in their nonfuel exports and the stimulative effects of a decline in their rates of inflation.

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The positive effects of the oil price decline would be passed on to consumers to varying degrees, with the West German Government inclined to pass most or all the benefits along to help increase growth. For other countries the passthrough would be more limited; Japan would probably allow its utilities to increase profits. France now seems likely to raise taxes to help curb its budget deficits.

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We also investigated the impact of oil prices falling well below $25 per barrel. The further prices fall, the more difficult and less precise are the predictions of economic effects. Clearly, most OPEC countries could not finance the current account deficits implied by continued unconstrained imports. Therefore, with oil priced at $15 and $20 per barrel, we assume that OPEC countries reduce imports sufficiently to prevent their deficits from exceeding those in the $25 per barrel case. Under this assumption, overall growth rates for the OECD with $15 or $20 per barrel oil would be only slightly higher than under the $25 per barrel scenario in the first year. The growth increment would, however, be substantially larger in the second and third years because the much more pronounced slowdown in inflation would increase domestic purchasing power.

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The uncertainties about the reactions of the major governments add to the imprecision in measuring the impact of sharp declines in the price of oil. The further oil prices slide, the more likely are governments of oil-importing countries to increase energy taxes as a means of reducing budget deficits and preserving conservation gains. Higher energy taxes or higher prices would, of course, dampen the stimulative impact of oil price cuts. Oil exporters, such as the United Kingdom and Canada, would have to look elsewhere for government revenues or suffer the inflationary pressures of larger deficits.

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The impact of lower oil prices on interest rates and the world debt problem is not clear. In our basic analysis, we assume that monetary authorities do not change monetary policy; that is, the nominal money supply and the nominal central bank discount rate are held constant. In that case, interest rates would be little affected; the initial drop in rates because of slowing inflation would quickly be offset by increased demand for investment funds. If the discount rates were reduced in line with inflation, economic growth would be much faster. Other, more judgmental, factors also would affect the level of interest rates. Perceptions could change concerning country risks, inflation prospects, the value of alternative investments, and the desired spread between inflation and nominal rates. As a result of those perceptions, interest rates could come down another percentage point or so despite the implied increase in the demand for money.

25X1

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Contents

25X1

25X1

OECD: The Economic Impact of a Reduction in Oil Prices

25X1

Introduction

OPEC recently lowered the reference price for crude oil to $29 per barrel. That reduction will have a favorable impact on the economies of the oil importers; if the price falls further, their benefits overall will be even greater. This paper analyzes in detail the impact on the developed countries of a further cut in oil prices to an average $25 per barrel and describes possible policy responses by the major governments. It also looks at other pricing possibilities and evaluates policy shifts if prices move further downward. We used a combination of econometric and judgmental analysis to develop our forecasts and to evaluate policy responses.[1]

The major assumptions used for these projections were:

- ***Oil Price.*** To set a baseline, we assumed that prices would remain at the 1 January 1983 level of $33.50 a barrel through 1985. In our alternative scenarios, we assumed that prices would fall to an average $25 a barrel, $20 a barrel, or $15 a barrel and would remain at those levels through 1985. All prices are in nominal terms.

- ***Government Policies.*** We assumed that governments in the baseline case would target the nominal money supply, the nominal central bank discount rate, and nominal government expenditures. We assumed that the governments would not change those targets as a result of the oil price decline. In alternative scenarios, we relaxed the assumptions for government monetary and expenditure policies. We assumed, for example, that the discount rate would fall with the inflation rate, thus reducing interest rates.

- ***Exchange Rates.*** In our baseline case, we assumed exchange rates would vary with the differences in inflation rates between countries. In the alternative scenarios, we assumed that exchange rates would remain the same as in the baseline case.

- ***OPEC Imports.*** With the baseline forecast of oil priced at $33.50 per barrel, we estimated the combined OPEC current account deficit at $25 billion in 1983 with even larger deficits in 1984 and 1985. With cheaper oil we believe several OPEC countries would face financial constraints. Therefore, in the $25 case we assumed that OPEC would reduce its imports of goods and services sufficiently to prevent its current account deficit from increasing by more than $30 billion above the baseline case in the first year, $15 billion in the second year, and $0 in the third year of the price cut. Because of OPEC's presumed inability to finance higher deficits, we assumed in the $20 and $15 scenarios that OPEC would cut its imports so that its current account balance would be the same as with $25 oil.

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The Overall Impact on the OECD [2]

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We estimate that, if crude oil prices fall 25 percent from their 1 January 1983 level to an average $25 a barrel for the year and remain at that price through 1985, OECD *economic growth* would be boosted a full percentage point the first year and another half percentage point in each of the next two years. The biggest stimulus to OECD growth would be the increase in real purchasing power in the oil-importing countries. A further stimulus to growth would result from the lagged effect of spending adjustments. For

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[1] Our analysis relies heavily on simulations using the CIA's Linked Policy Impact Model (LPIM) of the world economy. We believe that this model provides a good measure of the change in key macroeconomic variables such as real GNP and inflation. The model is also useful in highlighting differences among the OECD countries and in estimating the importance of different assumptions about policy responses. The model does not, however, contain enough detail to examine certain areas of interest such as the detailed budgetary impact of an oil price decline, or the impact of the decline on the various sectors of each economy.

[2] See the inset for a discussion of other forecasts.

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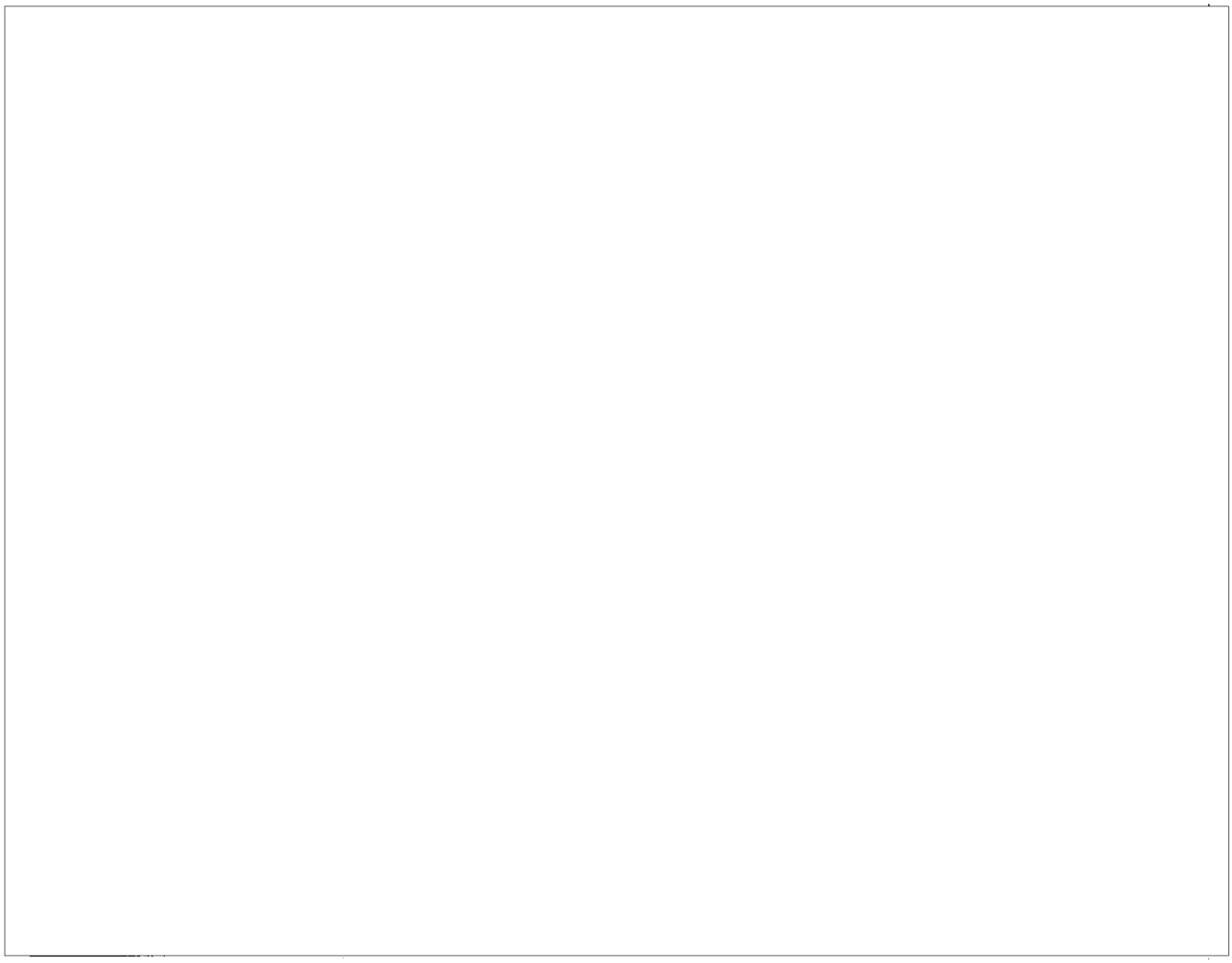

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example, government spending plans are made in nominal terms; assuming those plans are not quickly adjusted downward, more real goods are likely to be purchased with the same budgetary expenditures. Similarly, wage increases based on anticipated inflation rates will yield more spending in real terms than was expected when contracts were signed. Japan and Italy would enjoy the greatest stimulus in the first year because they are the largest energy importers relative to their GNP; even net energy exporters such as Canada and the United Kingdom would enjoy some increased growth as the volume of their nonfuel exports grows (see figure 1 and table 1).

OECD *inflation* rates would slow by about 1.5 percentage points in the first year. We estimate that the rate would average about 6 percent, with West Germany, Japan, and the United Kingdom all below 5 percent. The inflation bonus would dissipate quickly, however, as the one-time price cut effect is absorbed and other growth pressures begin to mount.

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Unemployment would not fall significantly in 1983 as a result of an oil price decrease. After three years, however, it would be down throughout the OECD by

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Figure 1
OECD Countries: Impact of Reduction in World Oil Prices to $25 Per Barrel

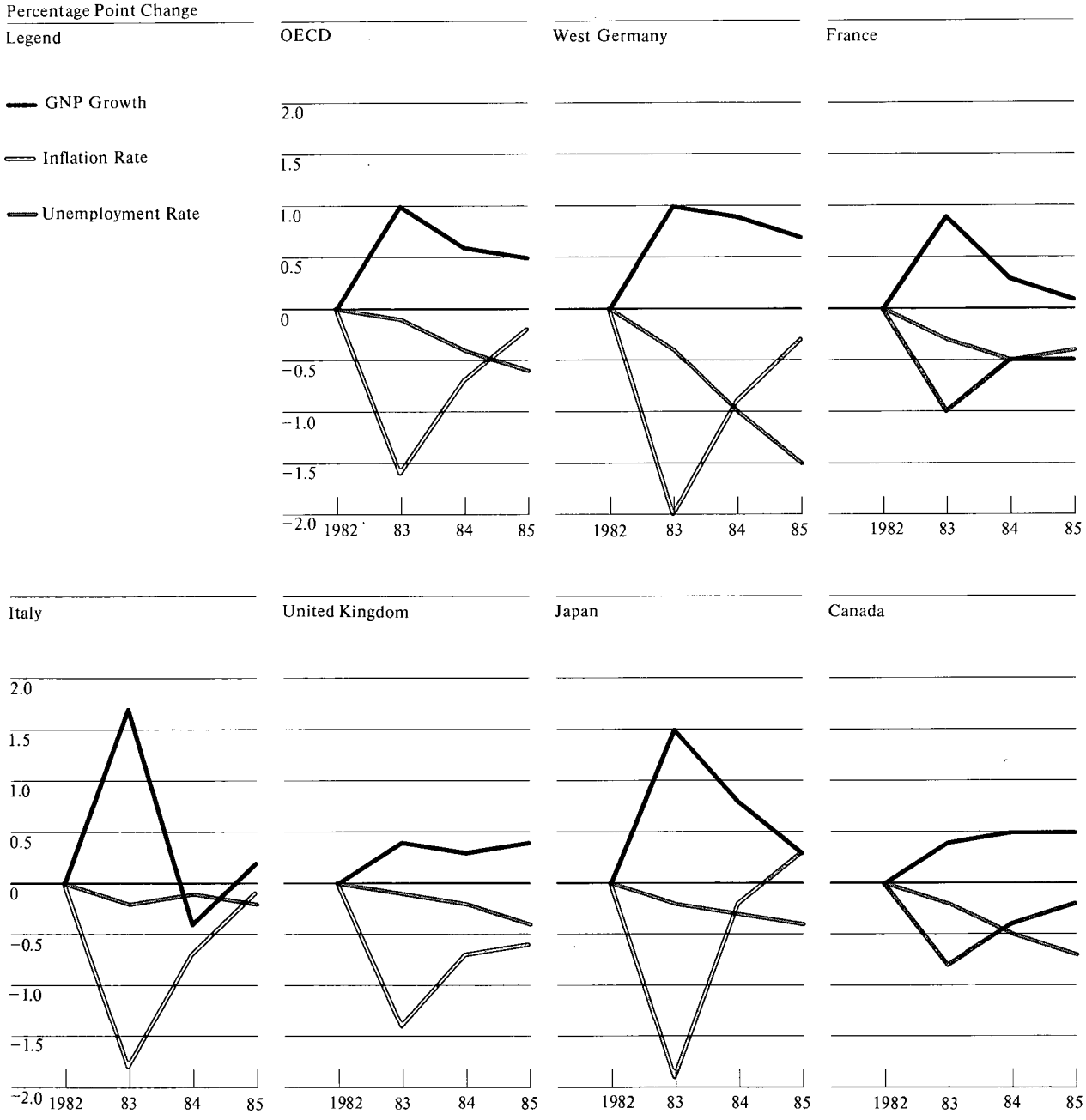

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Table 1
OECD: Changes Associated With a Fall in the Price of Oil From $33.50 to $25.00 Per Barrel

	West Germany	France	United Kingdom	Italy	Japan	Canada	Total OECD
Change in the growth rate of real GNP [a] *(percentage points)*							
1983	+1.0	+0.9	+0.4	+1.7	+1.5	+0.4	+1.0
1984	+0.9	+0.3	+0.3	−0.4	+0.8	+0.5	+0.6
1985	+0.7	+0.1	+0.4	+0.2	+0.3	+0.5	+0.5
Change in inflation rates *(percentage points)*							
1983	−2.0	−1.0	−1.4	−1.8	−1.9	−0.8	−1.6
1984	−0.9	−0.5	−0.7	−0.7	−0.2	−0.4	−0.7
1985	−0.3	−0.5	−0.6	−0.1	+0.3	−0.2	−0.2
Change in unemployment rates *(percentage points)*							
1983	−0.4	−0.3	−0.1	−0.2	−0.2	−0.2	−0.1
1984	−1.0	−0.5	−0.2	−0.1	−0.3	−0.5	−0.4
1985	−1.5	−0.4	−0.4	−0.2	−0.4	−0.7	−0.6
Change in current account balance *(billion $)*							
1983	+2.1	+3.6	−3.4	+1.9	+11.7	−0.3	+29.5
1984	−0.3	+1.6	−3.7	+0.9	+10.4	+0.0	+12.9
1985	−1.0	+0.8	−3.9	−0.1	+9.8	+0.3	+1.0

[a] The changes shown in this table are from a baseline forecast with oil priced at $33.50 per barrel. In the case of the GNP growth rates, the total benefits resulting from the oil price decline would be measured by the accumulation of the changes. For example, while Italy's GNP growth in 1984 as a result of the oil price decline in 1983 would be negative, the overall level of the Italian GNP in 1984 would still be 1.3 percent above what it would have been without the oil price reduction.

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some 2.5 million people—slightly more than 1 percent of the labor force—from what it otherwise would have been. By 1985 unemployment rates would be below 9 percent for all the major OECD countries except Canada and the United Kingdom.

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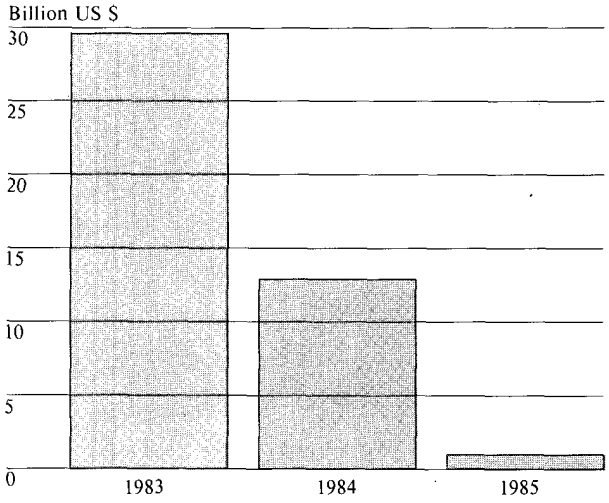
The *current account* balance of the OECD as a group would improve by some $30 billion dollars in the first year, but the gain would fall off rapidly in 1984-85. In the first year, the saving on oil imports for the OECD would be greater than the decline in exports to the oil-producing countries. Moreover, greater economic growth elsewhere in the world would lead to almost a $15 billion improvement in OECD exports—offsetting about three-fourths of the loss in exports to the oil producers. By 1985 the OECD current account balance would be about the same as in the baseline case of $33.50 per barrel oil because of the continued decline in OPEC imports and the growth-induced climb in OECD import demand. Japan's surplus would increase the most and remain higher through 1985 because the change in Japan's imports is a much

smaller share of the increase in GNP than for other major countries. For the other major OECD countries, increasing economic growth in the second and third years would lead to an increase in imports that would largely offset the trade improvement from lower oil prices. Our assumption is that exchange rates do not shift because of changes in oil prices. If exchange rates adjust to the large increase in Japan's current account surplus relative to the other OECD countries, Japan's surplus after three years would be considerably lower and the balances of the other OECD countries would be considerably improved (see figure 2).

Government *budget deficits* would be smaller with an oil price decrease because faster growth would generate more revenues. Unless nominal government expenditure targets are lowered in line with the declining rates of inflation, the improvement in budget deficits would be marginal. An additional improvement in budget deficits would depend on political decisions about taxing windfall savings. Taxing savings would reduce deficits but would rob the economies of some stimulative benefits from the price cuts. Some of the negative growth effects of reducing deficits also may be countered if interest rates move down and private investment rises.

Figure 2
OECD Countries: Change in Current Account Balance Resulting From Reduction in Oil Price to $25 Per Barrel



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Approved For Release 2007/08/13 : CIA-RDP84S00555R000100180002-2

An Analysis of Major Foreign Countries [3]

West Germany

Impact. A drop in oil import prices to $25 a barrel in 1983-85 would add about 1 percentage point to West Germany's real GNP growth rate in the first and second years and about 0.7 percentage point the third year. The lower oil price alone would reduce West Germany's import bill by approximately $6 billion. Assuming the government does not tax away the savings, both consumption and private investment would grow more rapidly; the inflation rate would drop by a full 2 percentage points in the first year, and prices would continue to moderate in 1984-85 as well.

The oil price decline would boost West Germany's current account surplus more than $2 billion in 1983, as import savings and exports to other oil-importing countries more than offset declines in sales to OPEC. West Germany's current account balance would be worse as a result of the oil price decline in 1984 and 1985, however. Increased domestic growth would stimulate imports while export growth would slow as sales to OPEC deteriorate (see table 2).

Table 2 *Percentage points*

West Germany: Change in Growth Rate of Real GNP Components Resulting From a Reduction in the Price of Oil to $25 a Barrel

	Baseline Forecast [a]	Change From Baseline Forecast Due to Oil Price Drop		
	1983	1983	1984	1985
GNP	0.0	+1.0	+0.9	+0.7
Private consumption	−0.4	+1.3	+0.5	+0.4
Investment	−1.5	+1.6	+1.3	+1.9
Government consumption	0.5	+0.5	+1.6	+0.4
Exports	1.2	+0.1	+0.5	+0.5
Imports	0.5	+0.8	+0.6	+0.7
Memorandum items				
Current account balance (*billion $*)	5.6	+2.1	−0.3	−1.0
Inflation rate	4.0	−2.0	−0.9	−0.3
Unemployment rate	9.5	+0.4	+1.0	+1.5

[a] Oil price assumed to remain at $33.50.

Policy. We believe the West German Government would not impose any significant oil tax increases if oil prices were to stabilize at $25 per barrel. West Germany is in its longest economic slump since World War II, and unemployment is at record levels; the government would not want to limit potential improvement in either employment or inflation. Bonn also would avoid any moves that would place its industry—heavily dependent on exports—at a price disadvantage vis-a-vis its OECD competition. On the other hand, we believe the new Kohl government would use new revenues from increased economic activity to reduce deficits rather than create more jobs as the opposition political parties would prefer.

The government undoubtedly is concerned that a drop in oil prices would jeopardize domestic energy conservation, development of alternative energy sources, and local exploration for oil and gas. Nevertheless, we believe that Bonn would wait until the price fell below $20 before considering any measures to counteract the impact of a price decline on conservation.

[3] The model also predicts the effects from the impact of an oil price reduction on the US economy because the United States is an integral part of the LPIM.

According to the LPIM results, if world oil prices drop to $25 per barrel, the incremental boost to US real GNP would be nearly 1 percentage point in the first and second years of the price cut, and 0.6 point in the third year. The oil price cut, other things equal, would result in a savings of approximately $16 billion in the US bill for imported fuel. This savings would lead by itself to an increase in real GNP of nearly 0.5 percent.

A 25-percent oil price cut would drive down average end-use energy prices in the United States by about 15 percent, assuming no new government policies to diminish the passthrough effect. The fall in energy prices would slow the rise in consumer prices by nearly 2 percentage points in the first year. Increasing economic activity, however, would push inflation rates back to the estimated baseline by 1985. In the short run, the slowdown in inflation would be a sharp stimulus to the economy. Because nominal wages react to price declines with a lag, real wages—and consequently real private consumption—would increase significantly in the first year. On balance, trade in nonoil goods would be little changed; the increase in exports to other oil importers would about match the decrease in exports to OPEC.

In the first year, a lag between the decline in interest rates and the slowdown in inflation would moderate the growth in investment. By the second and third years the positive stimulus of higher disposable income and higher household savings would boost housing investment while higher capacity utilization would encourage more investment in plant and equipment.

France

Impact. A 25-percent reduction in the price of OPEC oil would raise French real GNP growth nearly 1 percentage point the first year, with the increase in growth trailing off quickly over the next two years. The savings on the oil bill would be approximately $6 billion in 1983, about 1 percent of estimated GNP. This savings by itself—if passed on to consumers and then spent or saved according to past patterns of income use—would raise real French GNP by 0.8 percent in 1983. The total increase in growth would be somewhat higher because of the additional stimulus from other factors, such as the increase in real government consumption that would result as inflation slows and nominal spending targets remain unchanged.

The French current account balance would improve by some $3.6 billion in the first year. The savings from lower oil prices and the additional exports to other oil importers would more than offset the loss of French exports to OPEC countries and the growth-induced increase in French imports (see table 3).

If Paris completely passed through the oil price decline, French energy prices would drop about 14 percent in the first year causing the rise in retail prices to slow by about 1 percentage point. If, on the other hand, the French Government continued to increase taxes to drive down the French budget deficit, the French inflation rate would not slow as much. To the extent that French inflation outstrips that of its major trading partners, French GNP growth would slow because of the negative impact on net trade.

Policy. The French Government probably will not fully pass through an oil price decline. The tough economic austerity program announced in March included an energy tax designed to offset the price cut. While the government has not released full details, press reports indicate that Paris will introduce some type of variable tax on gasoline to keep pump prices at their current levels and may tax other refined products in order to hold down consumer spending on these goods

Table 3 *Percentage points*

France: Change in Growth Rate of Real GNP Components Resulting From a Reduction in the Price of Oil to $25 a Barrel

	Baseline Forecast [a]	Change From Baseline Forecast Due to Oil Price Drop		
	1983	1983	1984	1985
GNP	0.5	+0.9	+0.3	+0.1
Private consumption	−0.8	+0.9	+0.3	0.0
Investment	−2.8	+1.5	+0.2	+0.2
Government consumption	0.9	+2.7	+0.8	+0.9
Exports	3.3	0.0	−0.1	+0.4
Imports	−3.2	+1.5	+0.7	+0.1
Memorandum items				
Current account balance *(billion $)*	−9.1	+3.6	+1.6	+0.8
Inflation rate	10.0	−1.0	−0.5	−0.5
Unemployment rate	9.6	−0.3	−0.5	−0.4

[a] Oil price assumed to remain at $33.50.

The extent to which Paris would pass through additional oil price declines is difficult to assess. The government will have to balance the offsets between austerity, growth, exchange rates, and conservation. For example, it may pass on some of the price cut to mute the depressive effects of the austerity program on economic growth or if the French inflation rate gets out of line with those of its major trading partners. On the other hand, President Mitterrand may opt to raise taxes more in order to hold the budget deficit to the targeted 3 percent of GDP in 1983 and 1984.

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United Kingdom

Impact. We estimate that oil at $25 per barrel would push up British real GNP growth by less than 0.5 percentage point in each of the first three years. The drop to that price level would cut Britain's net energy exports by the equivalent of roughly 0.4 percent of GNP; the drop in manufactured exports to OPEC would reduce real GNP growth by another 0.5 percent. More than offsetting these negative effects, however, would be the increase in nonfuel exports to the rest of the world and the boost to real domestic demand from lower inflation. The rise in consumer prices would be 1.4 percentage points less in the first year. Lower inflation would stimulate the economy by pushing up the real value of nominal government expenditures, increasing real disposable income and consumer purchases, and causing a rise of investment by pushing savings up and interest rates down (see table 4).

The UK current account balance would decline by about $3.4 billion the first year following an oil price decline and slightly more than that in each of the next two years. Losses on energy exports account for two-thirds of the negative shift; growth-stimulated imports is the major factor accounting for the other one-third of the change in the deficit.

Policy. London would consider its policy reactions carefully with an eye to protecting economic recovery and to preserving the current Tory lead in the polls. We believe the Thatcher government would decide for these reasons to pass on most of the savings to consumers. The government would, however, further reduce taxes on oil companies to prevent a collapse of offshore exploration and development that would result in future supply constraints. As a result, budgetary pressures would probably grow, in which case the government could be forced to relax monetary policies to help finance a larger-than-expected deficit. The British would probably hope that the inflationary impact of larger budget deficits would be offset by the deflationary impact of cheaper oil.

Table 4 *Percentage points*

United Kingdom: Change in Growth Rate of Real GNP Components Resulting From a Reduction in the Price of Oil to $25 a Barrel

	Baseline Forecast [a]	Change From Baseline Forecast Due to Oil Price Drop		
	1983	1983	1984	1985
GNP	2.1	+0.4	+0.3	+0.4
Private consumption	1.9	+0.6	0.0	+0.2
Investment	3.0	+0.9	+0.4	+0.1
Government consumption	1.3	−0.1	+1.4	+0.9
Exports	1.3	−0.2	+0.2	+0.6
Imports	4.0	+0.3	+0.3	+0.5
Memorandum items				
Current account balance *(billion $)*	4.8	−3.4	−3.7	−3.9
Inflation rate	6.1	−1.4	−0.7	−0.6
Unemployment rate	13.3	−0.1	−0.2	−0.4

[a] Oil price assumed to remain at $33.50.

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Italy

Impact. The expansionary impact on Italy, more so than in the case of the other oil importers, would be heavily concentrated in the first year of the price cut; by the third year, the stimulus from reduced oil prices would be nearly exhausted. Energy imports are equivalent to approximately 7 percent of Italy's GNP; therefore, a 25-percent cut in oil prices would result in import savings of $6 billion, which would stimulate domestic spending and by itself boost real GNP growth by an estimated 1.4 percentage points in the first year. Inflation would be reduced by 1.5 percentage points. Lower inflation in turn would stimulate economic activity by increasing the real value of government expenditures and private consumption. This effect would quickly dissipate, however, as nominal wages and spending adjust to decreased inflation. The slower spending, coupled with further deterioration in export volume because of the slowdown in sales to OPEC, would also cause investment spending to slow. The cheaper oil, nonetheless, still would make Italy's current account balance better off than before an oil price decline (see table 5).

Table 5
Italy: Change in Growth Rate of Real GNP Components Resulting From a Reduction in the Price of Oil to $25 a Barrel

Percentage points

	Baseline Forecast [a]	Change From Baseline Forecast Due to Oil Price Drop [b]		
	1983	1983	1984	1985
GNP	0.4	+1.7	−0.4	+0.2
Private consumption	0.8	+2.5	−0.1	+0.2
Investment	−2.7	+2.7	−1.3	+0.2
Government consumption	1.5	+1.8	+0.6	0.0
Exports	2.5	−0.3	−0.3	+0.4
Imports	2.0	+3.0	−0.1	+0.6
Memorandum items				
Current account balance *(billion $)*	−5.1	+1.9	+0.9	−0.1
Inflation rate	14.0	−1.8	−0.7	−0.1
Unemployment rate	9.8	−0.2	−0.1	−0.2

[a] Oil price assumed to remain at $33.50.
[b] The changes shown in this table are from a baseline forecast with oil priced at $33.50 per barrel. In the case of the GNP growth rates, the total benefits resulting from the oil price decline would be measured by the accumulation of the changes. For example, while Italy's GNP growth in 1984 as a result of the oil price decline in 1983 would be negative, the overall level of the Italian GNP in 1984 would still be 1.3 percent above what it would have been without the oil price reduction.

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Policy. The Italian Government probably would not fully pass through a 25-percent cut in energy prices to consumers. When oil prices dropped somewhat last year, Rome limited the decline in domestic oil product prices and applied the additional revenues to help Italy's financially troubled electric utility industry. Nonetheless, the extent to which Rome would allow the price decline to be passed through would be hotly debated within the governing coalition. Austerity-minded Christian Democratic Treasury Minister Goria probably would press to keep oil product prices high through energy taxes and to apply the receipts to the burgeoning deficit. The Socialists, on the other hand, would probably press for passing some part of the price break to the consumers. The recently signed contract for high-priced Algerian natural gas with a take-or-pay provision indicates that Rome still plans to press ahead with its National Energy Plan for oil conservation and energy diversification.

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Japan

Impact. We estimate that a 25-percent reduction in the price of imported fuel would boost the rate of growth of Japanese real GNP by 1.5 percentage points in the first year and an additional 0.8 percentage point in the second year. The bulk of the positive impact would come from the $18 billion savings in the fuel import bill. Unemployment and inflation rates, already at low levels relative to other countries, would drop further. The Japanese economy would also be stimulated by increasing exports to other oil-importing countries, more than offsetting a drop in exports to OPEC. On balance, Japan's current account surplus would climb by $11.5 billion in 1983 and $10 billion in 1984 and 1985 over levels previously predicted[4] (see table 6).

Policy. We doubt that the Nakasone government or the Japanese energy industry would permit a complete passthrough of a fall in oil import prices. The Ministry of Finance indicated in late February that it was studying a $1 billion increase in energy taxes designed to encourage continued energy conservation and narrow the government's record budget deficit. We also believe that Japanese oil refiners and retailers, who have incurred heavy losses in recent years, would take advantage of falling oil prices to improve their own, rather than their customers', financial position. At the same time, electric utilities, which use oil to produce 45 percent of the country's electricity, would lower rates only if instructed to do so. At this point, we believe the Ministry of International Trade and Industry would push for selective price cuts in electricity to benefit only ailing energy-intensive industries and would instruct the electric utilities to earmark part of their windfall profits for investment in nuclear facilities.

[4] The impact of the oil price drop on the Japanese current account balance would be so large that it probably is unrealistic to assume the yen would not be affected. An appreciation of the yen could cause Japanese exports to decline and imports to rise; the increase in Japan's real GNP could thus be somewhat less than predicted. Japan's current account surplus in dollars would be even greater in the first year of the oil price cut, however, because it would take at least a year for the fall in the net trade volume to overcome the rise in the dollar value of net exports resulting from the yen appreciation.

Table 6 *Percentage points*

Japan: Change in Growth Rate of Real GNP Components Resulting From a Reduction in the Price of Oil to $25 a Barrel

	Baseline Forecast [a]	Change From Baseline Forecast Due to Oil Price Drop		
	1983	1983	1984	1985
GNP	2.7	+1.5	+0.8	+0.3
Private consumption	1.3	+1.0	+0.7	+0.5
Investment	6.9	+3.7	+0.8	+0.1
Government consumption	−4.6	+1.4	+0.5	−0.3
Exports	8.0	−0.3	+0.6	+0.6
Imports	4.8	+1.6	+1.0	+0.9
Memorandum items				
Current account balance (*billion $*)	11.9	+11.7	+10.4	+9.8
Inflation rate	5.0	−1.9	−0.2	+0.3
Unemployment rate	2.6	−0.2	−0.3	−0.4

[a] Oil price assumed to remain at $33.50. Baseline numbers do not reflect upward revision of historical national income accounts data.

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Canada

Impact. Despite oil export losses, Canadian real GNP growth would increase by nearly 0.5 percentage point in each of the three years following an oil price decrease. Canadian losses resulting from lower fuel export prices would be offset by higher nonfuel export volume to the United States and other OECD countries as world economic activity recovered. Because Canada has only a very small share of the OPEC market, decreased sales to those countries would have little effect on the Canadian economy. Canada's inflation rate would decrease less than in any of the other major industrial countries because oil prices in Canada have traditionally been held below world levels. The estimated 0.8-percentage-point improvement in inflation in the first year of the oil price cut would stem mainly from the secondary price benefits of the reduced cost of nonfuel imports. On balance, there would be very little change in Canada's current account surplus over the three-year period as a result of an oil price change (see table 7).

Policy. We believe that Prime Minister Trudeau would allow domestic oil prices to remain steady as world oil prices fell, forgoing his 1980 election promise to keep domestic oil prices well below world levels. Canada's oil pricing policy, embodied in the National Energy Program (NEP), is intended to maintain a domestic price at no higher than 75 percent of world oil prices. A 25-percent drop in the world price would require a cut in the domestic price from the current $24.10 per barrel to about $18.75 per barrel, costing the Canadian federal government $8 billion in lost energy tax revenues over three years. Ottawa, facing a $22 billion federal deficit for fiscal year 1982/83, could ill afford more than the $25 billion deficit already being forecast for 1983/84 on the basis of current oil prices.

We expect that Trudeau would try to maintain oil conservation efforts outlined in the NEP. He would keep domestic natural gas prices at 65 percent of domestic oil prices on an oil-equivalent basis to encourage the use of Canada's abundant natural gas resources. That would mean canceling scheduled price increases but would not necessarily lead to a drop in present domestic prices. A drop in world prices would probably also mean shelving some of Canada's offshore oil projects

Table 7
Canada: Change in Growth Rate of Real GNP Components Resulting From a Reduction in the Price of Oil to $25 a Barrel

Percentage points

	Baseline Forecast [a]	Change From Baseline Forecast Due to Oil Price Drop		
	1983	1983	1984	1985
GNP	1.2	+0.4	+0.5	+0.5
Private consumption	0.2	+0.4	+0.4	+0.4
Investment	2.6	+0.1	+0.4	+0.4
Government consumption	1.7	+0.2	+0.5	+0.3
Exports	1.5	+0.8	+1.0	+1.0
Imports	1.0	+0.5	+0.7	+0.8
Memorandum items				
Current account balance (*billion $*)	1.8	−0.3	0.0	+0.3
Inflation rate	7.4	−0.8	−0.4	−0.2
Unemployment rate	12.2	−0.2	−0.5	−0.7

[a] Oil price assumed to remain at $33.50.

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Sensitivity Scenarios

The results of our forecasts strongly depend on the choice of assumptions. Other plausible assumptions could lead to significantly different results

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Reduced OPEC Imports

Our assumption about the size of the cutback in OPEC imports is very important to the estimate of the overall impact of an oil price cut, particularly in the first year. In our $25 oil case, we assumed that the financially constrained OPEC countries would trim desired imports by nearly $20 billion in 1983 in order to keep their current account deficit from worsening by more than $30 billion (from a $25 billion deficit in the baseline case to $55 billion in the $25 case). If OPEC cut imports even more, OECD growth would be less. For example, if OPEC reduced imports in the first year by the total amount of the revenue loss—some $50 billion for $25 oil—OECD growth would increase by only 0.3 percentage point in 1983 as opposed to 1 point with higher OPEC imports (see table 8). In the second and third years OECD growth rates would pick up because the negative impact of the reduction in exports to OPEC would have been absorbed. By the end of the third year, the level of overall OECD GNP would be only slightly less than in the case of spreading the reductions in exports to OPEC over three years. If OPEC did not cut imports by as much as we predicted for the alternative price scenarios, OECD growth would be higher in the first year than in the $25 case

Cheaper Oil

To test the incremental impact of further oil price drops, we ran scenarios of average oil prices at $20 and $15 per barrel through 1985 (see figure 3). For those cases, however, we assumed that the financially constrained oil exporters could not increase their current account deficits further. As a result, we held the OPEC current account deficit in both cases to no more than the $55 billion implied by the first $25 oil case. This constraint would impose a total reduction in OPEC imports of some $50 billion in the first year for $20 oil and $80 billion for $15 oil. (The domestic impact of these OPEC import cutbacks could be severe enough to shock OPEC into a new sense of unity or to cause political instability in key members; either development could limit the duration of markedly lower oil prices.)

Figure 3
OECD Countries: Change in Growth Rate of Real GNP Under Various Oil Price Assumptions

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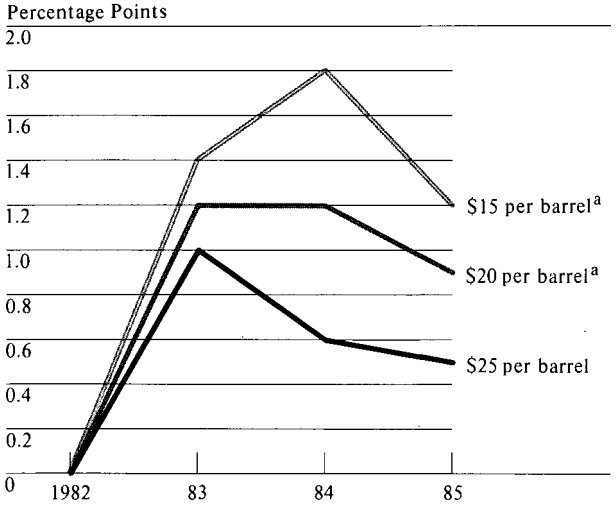

[a] OPEC current account deficit constrained to level of the $25 oil case.

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Assuming no worsening in OPEC current account balances beyond the $25 case, OECD growth in the first year with $20 per barrel oil would be 1.2 percentage points higher than in the $33.50 case (see table 9) and a mere 0.2 percentage point higher than with $25 oil. Among the foreign OECD members a few—notably West Germany and the smaller countries—would actually lose more from falling OPEC imports than they would gain from the additional stimulation from lower oil prices. The boost in trade generated by faster economic growth in the United States and other major countries would stimulate growth across the board in the second and third years. By the third year, the level of total OECD GNP would be 1 percent higher than under the $25 case and 3 percent higher than the $33.50 case.

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Table 8
OECD: Change in Growth Rates of Real GNP With a Drop in Oil Prices From $33.50 to $25 Per Barrel [a] and a Reduction in OPEC Imports by the Full Amount of Lost Revenues

Percentage points

	West Germany	France	United Kingdom	Italy	Japan	Canada	Total OECD
1983	−0.4	+0.2	−0.3	+0.8	+0.4	0.0	+0.3
1984	+1.6	+0.4	+0.7	+0.2	+1.2	+0.6	+0.9
1985	+1.2	+0.5	+0.5	+0.4	+1.2	+0.6	+0.7

[a] The difference between these figures and the figures for GNP growth shown in table 1 reflect the incremental impact on the OECD countries of a change in the assumption about how quickly OPEC adjusts its imports to a large drop in oil export revenues.

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Table 9
OECD: Changes Associated With a Fall in the Price of Oil to $20.00 a Barrel From $33.50 [a]

	West Germany	France	United Kingdom	Italy	Japan	Canada	Total OECD
Change in the growth rates of real GNP [b] *(percentage points)*							
1983	+0.8	+1.0	+0.4	+2.1	+1.8	+0.4	+1.2
1984	+1.8	+0.6	+0.7	−0.3	+1.5	+0.9	+1.2
1985	+1.2	+0.5	+0.6	+0.3	+0.7	+0.8	+0.9
Change in inflation rates *(percentage points)*							
1983	−3.2	−1.7	−2.2	−3.0	−2.9	−1.3	−2.6
1984	−1.5	−1.0	−1.0	−1.0	−0.5	−0.7	−1.1
1985	−0.5	−1.4	−1.0	−0.2	+0.4	−0.4	−0.3
Change in unemployment rates *(percentage points)*							
1983	−0.3	−0.3	−0.1	−0.2	−0.2	−0.2	−0.1
1984	−1.2	−0.5	−0.3	−0.1	−0.5	−0.6	−0.5
1985	−2.2	−0.7	−0.6	−0.2	−0.7	−1.2	−1.0
Change in current account balance *(billion $)*							
1983	+0.9	+4.5	−6.8	+2.3	+16.2	−1.0	+31.3
1984	−1.1	+2.3	−6.5	+1.2	+15.7	−0.2	+13.3
1985	−2.1	+0.7	−6.6	−0.2	+15.3	+0.5	−3.3

[a] These estimates assume that OPEC would reduce its imports sufficiently to ensure that its current account deficit would be no larger than in the $25 scenario.
[b] The changes shown in this table are from a baseline forecast with oil priced at $33.50 per barrel. In the case of the GNP growth rates, the total benefits resulting from the oil price decline would be measured by the accumulation of the changes.

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Table 10
OECD: Changes Associated With a Fall in the Price of Oil to $15.00 a Barrel From $33.50 [a]

	West Germany	France	United Kingdom	Italy	Japan	Canada	Total OECD
Change in the growth rates of real GNP [b] *(percentage points)*							
1983	+0.6	+1.2	+0.4	+2.6	+2.1	+0.6	+1.4
1984	+2.6	+0.8	+1.0	−0.3	+2.2	+1.6	+1.8
1985	+1.9	+0.7	+0.8	+0.5	+1.1	+1.2	+1.2
Change in inflation rates *(percentage points)*							
1983	−4.4	−2.2	−3.0	−4.2	−3.9	−1.9	−3.8
1984	−2.0	−1.3	−1.3	−1.2	−0.6	−1.0	−1.5
1985	−0.6	−1.4	−1.2	0.0	+0.6	−0.5	−0.2
Change in unemployment rates *(percentage points)*							
1983	−0.2	−0.3	−0.1	−0.2	−0.3	−0.2	−0.2
1984	−1.4	−0.6	−0.4	−0.2	−0.6	−0.8	−0.6
1985	−2.8	−0.9	−0.7	−0.2	−0.9	−1.7	−1.4
Change in current account balance *(billion $)*							
1983	−0.4	+5.4	−10.1	+2.7	+20.8	−1.6	+33.4
1984	−2.2	+2.9	−9.1	+1.4	+20.5	−0.3	+12.2
1985	−2.7	+1.4	−8.4	−0.3	+20.5	+0.8	−3.9

[a] These estimates assume that OPEC would reduce its imports sufficiently to ensure that its current account deficit would be no larger than in the $25 scenario.
[b] The changes shown in this table are from a baseline forecast with oil priced at $33.50 per barrel. In the case of the GNP growth rates, the total benefits resulting from the oil price decline would be measured by the accumulation of the changes.

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Unemployment and inflation would drop faster everywhere. The unemployment rate would be about the same in the first year and decline in the next two years, whereas inflation would fall more in the first year than later. Current account balances would be only slightly improved over the $25 oil case because lost sales to OPEC and higher imports would be roughly offset by cheaper oil. Continued increases in imports, however, would worsen the overall OECD deficit in later years. Japan's current account surplus would improve sharply and remain high because of more exports to the United States and cheaper oil prices. For most of the other OECD countries the loss of sales to OPEC would roughly offset savings on oil imports; thus there would be only a slight difference in their current accounts between the $25 and the $20 cases.

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The pattern of change in moving to $15 oil would be much the same, only more so (see table 10). Growth would be up a little and inflation rates and unemployment would decline even more than under previous cases. Current account balances would remain little changed from the $25 case because the continued fall in OPEC imports would counter the oil-bill savings.

The improvement in Japan's surplus would increase more sharply than the others; as a result, additional pressures would surely mount on the yen.

Governments in the major oil-importing countries probably would prevent domestic oil prices from falling much below the $20 level. Most would tax away gains to curb deficits and to prevent a turnaround in energy conservation. The oil exporters would have different problems. The Canadians probably would reduce domestic prices as they fell below $25 per barrel in order to keep them at or below world levels. If so, other taxes—most likely on industry—would have to be increased to offset lost revenues. In Britain, a drop in oil prices to $20 per barrel would threaten the profitability of North Sea production in existing wells and would end exploration and development activity.

Adjusting Monetary Policy

In all the estimates previously described, we assumed that governments would target the nominal money supply and that there would be no change in monetary policy. As a result, the impact of the oil price cut on interest rates would be quite small. In an alternative scenario, we assumed monetary policy would allow short-term interest rates to drop in each country in line with the fall in the inflation rate. Long-term rates would fall less quickly, but the impact nevertheless would be a considerable extra stimulus to growth in all of the major industrial countries. We estimate that a 25-percent oil price cut, accompanied by these adjustments in monetary policy, would result in OECD aggregate real GNP growth increasing by 1.5 percentage points in the first year, compared with the estimate of a 1.0-point increase under our previous assumption. (See the inset for other financial developments that may result from a fall in oil prices.)

Adjusting Government Consumption

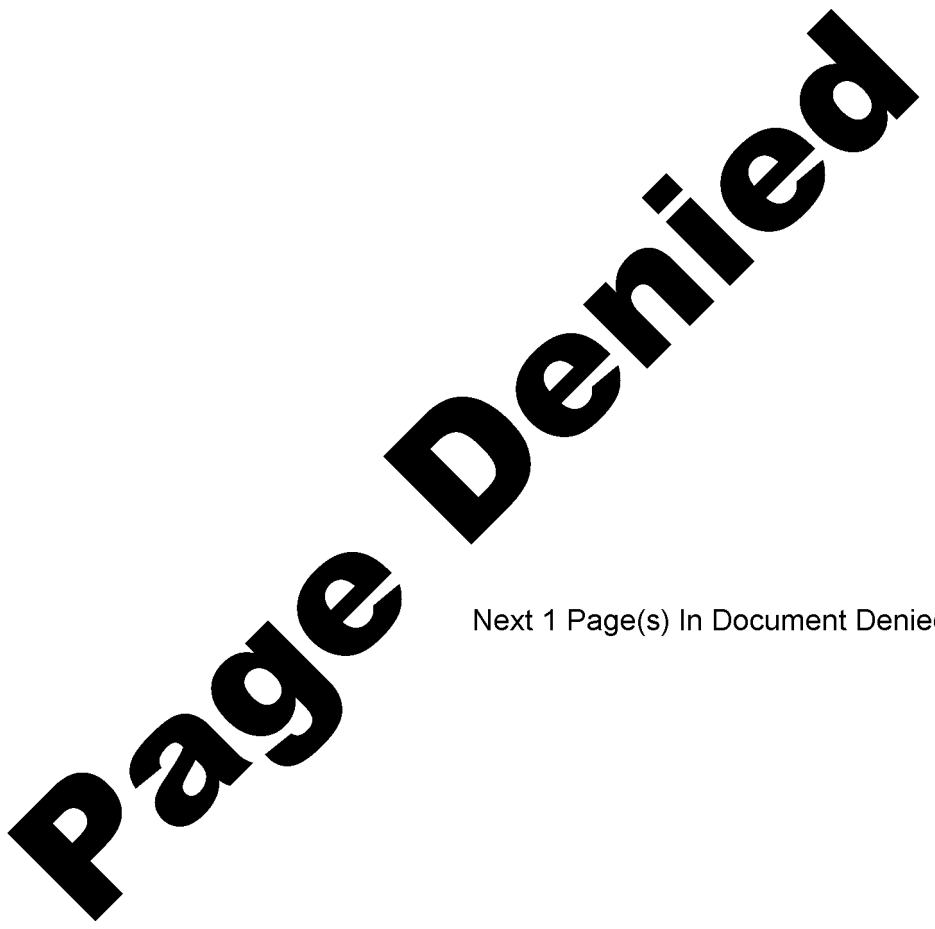
We also assumed, in our estimates, that nominal government consumption in each country would remain unchanged from the $33.50 per barrel scenario. The result was that real government consumption would increase substantially in most countries. In an alternative scenario, we adjusted nominal government consumption downward proportional to inflation rates in 1984 and 1985 to hold expenditures constant in real terms. Under that assumption, the estimated increase in OECD real GNP growth rates would be only 0.2 and 0.3 percentage point in 1984 and 1985 compared with 0.6 and 0.5 percentage point for those years under the $25 case with nominal government expenditures unchanged

Financial Implications of Cheaper Oil

The shift of income from oil producers to oil consumers would not by itself change the amount of Western banks' liabilities, only the source of deposits. Because most of the OECD countries are oil importers, the shift would represent a swing in favor of domestic deposits over foreign—largely OPEC—deposits. The balance-of-payments changes that would result from declining oil prices imply there might be less foreign direct investment in the OECD countries and a smaller share of government debt held by foreigners; more of the funds for US investment would probably be supplied by domestic savers. Large countries where individual incomes would increase most—the United States, West Germany, and Japan—would supply a relatively larger share of the funds for investment and government debt financing for themselves as well as for the other OECD countries. To the extent that the oil importers hold assets in a different portfolio mix than oil producers, the relative prices of those respective assets would change.

The uses of funds by banks do not depend on the origin of depositors but rather on the banks' perception of risk and potential profits. The world's energy producers and the banks that hold large amounts of their debt would be hurt by a drop in oil prices. *during the last round of oil price hikes in 1979 and 1980, banks were making energy project loans based on $25 per barrel oil. Slippage of oil prices below that level would probably lead to banks writing off some loans as projects become uneconomical and others shut down because of the squeeze on profits.*

A drop in the price of oil could also reduce inflationary expectations and lead to a further decline in interest rates. For every 1-percentage-point drop in the interest rate, the debt servicing costs for the LDCs would drop by about $5 billion.



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